



# Securities Arbitration in Kansas: Has the Dust Finally Settled?

By Jeff Kruske

Since the stockmarket decline began in March 2000, the public eye has centered on the nation's financial markets. From the bullish recommendations of the local stockbroker to the fraudulent and biased research advice of Wall Street's elite, the last four years have been an unprecedented time of financial education and financial awareness for most Americans.

At the heart of this sustained market downturn is the investor, from the middle-class couple who were counting on retiring in a few years, to the thirty-something parents with three kids who saw their college fund disappear before their very eyes. As the markets declined, many investors were left scratching their heads, wondering if they had just experienced what their broker referred to as a typical market "correction" or, worse yet, if their losses were a direct result of their broker's negligence.

This article will explain and clarify the various nuances in representing the individual investor in securities disputes and outline the various theories of liability and methods of recov-

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ery available to Kansas investors.

When attorneys think of "securities law," most are typically referring to "securities regulation," which deals with the underwriting, registration and distribution of initial public offerings, insider trading and the like. Securities fraud practice, however, is more specific. Although the number of attorneys who specialize in representing investors has grown over the past several years, there are still less than 800 across the nation, most practicing on the east and west coasts.

Kansas attorneys should note that in the vast majority of these cases, maintaining a securities fraud practice is virtually the same as maintaining an arbitration practice. Prior to 1987, investor claims were primarily pursued in federal court; the securities industry fought long and hard to move the primary forum of dispute resolution

away from the public courts to private, industry-sponsored arbitration at the New York Stock Exchange (NYSE) or the National Association of Securities Dealers (NASD), the self-regulatory organizations that police the financial markets.<sup>1</sup>

Most customers who maintain an investment account at a national or regional brokerage firm sign an "opening account agreement" prior to depositing funds with their broker. Normally located in the fine print on the back of these agreements is a *pre-dispute arbitration clause*, which binds both the investor and the broker to resolve all disputes by way of arbitration. By forcing the customer to arbitration, the typical avenue of filing a civil complaint is eliminated.

NASD arbitration handles the majority of customer complaints in the Kansas City area. Arbitration is binding on the parties with generally no right to an appeal. Depositions and interrogatories are not allowed, and dispositive motions are rarely filed.<sup>2</sup> Although a customer can expect to pay a filing fee in the neighborhood of \$1,400 to initiate his or her claim, securities arbitration is a relatively inexpensive process that takes 12-18 months to resolve, assuming that it is not settled prior to hearing.

What then, can a customer sue their broker for? Typical cases involve violations of state and federal securities laws, breach of contract, negligent misrepresentation, breach of fiduciary duty and, in some cases, common law fraud. Most complaints assert violations of NASD rules, which brokers are bound to follow as part of their membership. These rules include a "duty of fair dealing" to the customer and a duty to recommend investments



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that are suitable (given the customer's investment objectives and goals).

If a broker recommends stocks to a client that do not fit his stated investment desires, a potential claim exists. The same is true if a customer can prove that the broker misrepresented material facts, failed to disclose key information, traded without authority, overconcentrated the client's account in specific market sectors, did not explain the added risks of margin trading, or excessively traded the account to generate commissions for himself.

The Kansas Securities Act<sup>3</sup> ("the Act") is particularly powerful and should receive special mention here. In 1911, Kansas passed the first "comprehensive" securities laws requiring registration of both securities and promoters.<sup>4</sup> The Kansas law was a response to unwitting investors being taken by salesmen selling worthless interests in fly-by-night companies and gold mines all along the back roads of the state.<sup>5</sup> It was reportedly said that no assets backed up those securities—nothing but the blue skies of Kansas.<sup>6</sup> Thus, the Kansas act was the first of the "blue-sky laws." To this day, state laws regulating securities are known throughout the industry as blue-sky laws.

Not much of the Act has changed since its inception. The Kansas Securities Act also provides more generous remedies than those that are available under federal securities laws. Notably, the Act imposes liability upon merely negligent actors for selling securities by means of any material misrepresentation. The Act provides for rescissionary damages, reasonable attorney fees, punitive damages and 15% prejudgment interest.<sup>7</sup>

As a general rule, clients want to sue their brokers because they lost money or felt they were charged excessively for services. Since the market bubble burst in 2000, securities attorneys have prevailed on a number of theories, the strongest of which will be outlined here. First and foremost, almost all securities fraud claims involve some sort of "suitability" issue. Put another way, a claim is alleged against a broker for recommending or investing their client in an unsuitable stock or mutual fund.

For instance, a broker may violate

his duty to invest his clients suitably and prudently if he recommends to his client that he invest his IRA funds in speculative penny stocks or mutual funds that have a volatile track record. Another claim typically associated with retirement funds is concentrating clients' money in a particular market sector, such as technology or telecommunications. The more egregious cases involve brokers buying and selling a client's holdings for the purpose of generating commissions and fees for himself. Even if a client's account makes money, the broker can still be held liable for churning, where the appropriate remedy is disgorgement of commissions.

### What Damages are Recoverable Under Kansas Law?

The Kansas Securities Act provides for recovery for a defrauded investor in terms of rescission and damages. In general terms, the statute operates on a rescission principal. The rescission concept is consistent with the intent of the Act, that the investor should be made whole. To make the investor whole, he should be able to have the price of the securities refunded to him plus all expenses and costs incurred in the action.<sup>8,9</sup>

When an investor still owns the securities he is suing on, it is clear that the remedy is statutory rescission. An investor may not keep the securities and sue for damages. As such, rescission requires the investor to tender the return of the securities if he is seeking a refund of the purchase price. Furthermore, under rescission damage calculations, the investor must also give back any income he has received in the form of interest, dividends, capital distributions, and the like.

In exchange, under the Act the investor receives a return of his investment plus interest on the investment from the date of investment to the date of payment plus costs and attorney fees.<sup>10</sup>

When the investor no longer owns the securities, the Act provides that the investor should be able to recover damages. The Act does not define damages in this context, but a practical application of common law damages in securities actions would likely provide that damages are equal to the

purchase price less the value of the securities when they were disposed of by the investor.<sup>11</sup>

The Kansas Securities Act precludes netting gains in unrelated securities against losses in the securities about which the customer complains. Under the Act, a sale which violates the act is voidable at the election of the purchaser.<sup>12</sup>

Equally important, the statute gives the purchaser the option of how to seek relief.<sup>13</sup> The fact that there were profits on a prior investment is irrelevant. This is true in federal and state courts. The majority of courts addressing the issue have rejected netting in securities cases. This issue was recognized in *In re Clinton Oil Company Securities Litigation*.<sup>14</sup> Here, the court analyzed the netting issue in terms of policy and statutory language under Rule 10b-5.<sup>15</sup> The court determined that allowing the defendants to offset profits would undermine the remedial purpose of securities laws by allowing wrongdoers to potentially escape liability.<sup>16</sup> The court's conclusion was that net profits and losses realized on sales of stock acquired in a single purchase transaction should be offset, but profits and losses on sales of shares obtained in separate and independent purchase transactions should not be offset for the purpose of reaching a net figure.<sup>17</sup> Courts in at least six other jurisdictions interpreting blue sky statutes similar to the Kansas Securities Act have also held netting improper.<sup>18</sup>

The leading federal case construing damages under state law is *Kane v. Shearson Lehman Hutton*.<sup>19</sup> In *Kane* the customer's claims involved purchases and sales of stock issued by one company. On one trade, the customer made a profit; on another the customer had a loss. Shearson argued the two trades should be netted against one another. The customer claimed that as a matter of policy and statutory construction Shearson was wrong.

In interpreting the Florida Securities Act, the Eleventh Circuit first observed that the remedial goals of the securities laws weighed heavily against Shearson's contentions:

What is found under both federal and Florida law, is the intent to have securities anti-fraud provisions enforced

stringently to deter fraud. As the district judge noted, 'If the... methodology espoused by [Shearson] were adopted, it could serve as a license for broker-dealers to defraud their customers with impunity up to the point where losses equal prior gains.'<sup>20</sup>

The *Kane* court then turned to the text of the Florida statute and concluded that the language negated any legislative intent to permit netting:

[T]he plain language of the statute reveals the intent to allow a purchaser fraudulently induced into purchasing a security to rescind his purchase, or, if he has already sold at a loss, to be put by an award of damages in as good a position as if he had rescinded the transaction. There is no indication that other transactions are relevant to this calculation at all.<sup>21</sup>

Similarly, in *Davis v. Merrill Lynch*, the Eighth Circuit Court of Appeals affirmed the district court's entry of judgment on a jury verdict awarding damages to the plaintiff based on violations of federal securities laws, common law fraud and breach of fiduciary duty.<sup>22</sup>

Thus, the investor may, but does not have to, sue to set every transaction aside; he may elect to keep some transactions and reject others. Defendants will often try to persuade the arbitrators that the investor must accept or reject all transactions and may only recover the "net loss" in the account. Clearly the investor is free to pick and choose and naturally will reject transactions in which they have suffered a loss, while retaining transactions in which they made a profit.<sup>23</sup>

### Suitability Claims

Claims for "unsuitable" investment advice is the most common type of case filed against brokers and brokerage firms. This general claim is at the heart of almost every type of case (whether it involves churning, unauthorized trading, or the like) because a broker is not permitted to recommend or solicit an investment strategy until they determine that the recommendation is consistent with the customer's investment objectives, financial needs, and risk tolerance.<sup>24</sup>

When a solicited investment was inappropriate for a certain investor and the broker knew or should have known that it was so, the issue is one of unsuitability.<sup>25</sup> Clearly, a broker has an obligation to recommend only suitable investments and trading strategies. Some examples of suitability claims include:

1. Option trading for an investor dependent on regular dividend income
2. Sale of limited partnership interests to individuals needing short-term liquidity
3. Mutual funds with an investment objective that is different from the customer's
4. Recommendation of a margin account for an individual with insufficient net worth to meet margin maintenance calls

It is important to note that what may be suitable for one investor can easily be unsuitable for another. While most investors seek to increase the value of their portfolio, few appreciate the risks in most investment strategies. As such, it is the task of the broker to learn about a customer's income, current investment portfolio, retirement plans and net worth so that the broker can be fully informed so as to recommend an investment consistent with the customer's needs and risk tolerance. While most investors understand that there is some risk involved in investing in the stock market, the majority of investors are not able to *assess the risk* of the specific recommendation made by the broker.

### Concentration

When a customer's account is abnormally weighted in limited market sectors, a bull market will typically cause a sharp rise but will also magnify the losses when the market corrects. The classic example was the sustained appreciation of the technology sector in the late 1990s. Customer attorneys often refer to concentration cases of that era as "tech wreck" cases, or situations in which brokers recommended virtually nothing but technology stocks to their clients, resulting in their portfolios being allocated among different stocks and mutual funds but

concentrated primarily in the technology industry.

Virtually all brokerage firms acknowledge that diversification among asset classes is one of the cornerstones of investing, no matter what type of investor they have for a client.<sup>26</sup> As a rule, portfolios should be sufficiently diversified so that all major asset categories are represented.<sup>27</sup> Investors can also manage investment risk through asset allocation (emphasis you should place on stocks for growth, bonds for income, and cash reserves for safety and liquidity). These concepts are not new, and the brokerage industry has espoused these benefits for years and years.

Diversification's nemesis, of course, is concentration. Concentration falls under two primary causes of action: negligence and fraud-related claims (common law and statutory). Negligence is the easier to prove by way of the Kansas Securities Act. Stockbrokers have a myriad of duties, one of which is the duty to recommend only suitable investments.<sup>28</sup> When an account is overconcentrated, it is *de facto* unsuitable.

The industry standards of care are set forth by the rules of the NASD, the NYSE, and the SEC; the regulators' interpretations of their rules, federal and state statutes, including the Kansas Securities Act; the federal Securities Exchange Act; and compliance manuals of brokerage firms.

In these instances, the most compelling evidence of the seriousness of concentrating a client's account consists of regulatory decisions evidencing suspensions and fines on brokers for overconcentration.

For years, the NASD has routinely fined and sanctioned brokers for concentrating their clients' accounts.<sup>29</sup> In addition, regulators have fined brokerage firms for not having in place supervisory procedures designed to catch overconcentration and for failing to implement those procedures.<sup>30</sup>

Classically, people think of concentration as putting a large percentage of an investor's assets in one stock. But if an investor had numerous stocks in the technology industry, for example, the diversification in numerous securities provides no protection due to the concentration within a particular in-

dustry. Generally, diversification requires investment in securities that are not affected by the same variables.<sup>31</sup>

When discussing the issue of concentration or lack of diversification, there are two different aspects to it. The first is what percentage of the investor's portfolio should be in stocks versus cash, bonds or other investments. The second is what percentage of only the stock portion of the investor's portfolio should be in certain types of stocks, industries or sectors of the market.<sup>32</sup>

Oftentimes attorneys will represent a client who arguably wanted to undertake additional risk in their portfolio in hopes of higher-than-average returns. While a customer is perfectly within his or her rights to pursue such a strategy, the self-professed riskiness may not be a viable defense for a brokerage firm who adopted their client's strategy.<sup>33</sup> Similarly, the acquiescence of the investor to the unsuitable investments is irrelevant.<sup>34</sup> These situations can be framed as "financial suicide" cases and are discussed below.

Concentration is a common element in suitability claims and should be carefully analyzed in the context of asset allocation and market diversification.<sup>35</sup>

### Unauthorized Trading

Unauthorized trading occurs when trades are executed in a customer's account without obtaining approval beforehand, either orally or by written discretionary authority granted to the broker or to a third party. One of the challenges in proving that unauthorized trading took place is posed by the customer's receipt of confirmations and monthly account statements. Essentially, the customer must prove a negative.

The ratification defense will almost always be raised by defense counsel in these types of cases. Since ratification is an equitable defense, it should be noted that for a defendant to *seek* equity, they must *do* equity. That is, for a brokerage firm defendant to enjoy the defense of ratification, they must *not* have "unclean hands" themselves. Proof of a broker's fraudulent conduct tends to vitiate the ratification defense in arbitration cases, especially if the so-called ratification was not a clear indication that the customer intended

to adopt the broker's actions.<sup>36</sup>

The federal courts have held that unauthorized trading is not actionable without an accompanying misrepresentation or nondisclosure.<sup>37</sup> In *Rivera v. Clark Melvin Securities Corp.*<sup>38</sup> the court concluded: "A broker's failure to inform an investor of transactions made on his or her account is itself a material omission, and, in fact, 'no omission could be more material than that.'"<sup>39</sup>

Similarly, in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng*,<sup>40</sup> the court concluded that a broker's duty to a customer—under the basic principles of agency law—encompasses the duty to inform the customer of the right to *reject* unauthorized trades and that the failure to do so, as a matter of law, constitutes a breach of that duty. Since the customers in this case were not informed of their right to disavow the unauthorized trades, said the Court of Appeals, "there could not have been ratification" of such trades.<sup>41</sup> "Ratification occurs only," said the court, "when the customer, with full knowledge of the facts, manifests his intention to adopt the unauthorized transaction."<sup>42</sup>

### Churning

Broker-customer disputes often involve allegations that a brokerage firm and the broker "churned," or excessively traded, the customer's portfolio in order to generate income for the firm and broker without regard for the customer's best interests.<sup>43</sup> At the root of churning cases is the issue of whether there was reasonable probability that the securities trading would be profitable enough to cover the cost of the trading. Proof of churning involves three elements: excessive trading, effective control by the broker, and self-interest of the broker.<sup>44</sup>

In most instances, brokerage firms defend churning allegations by stating that the customer controlled their own investments and that the high costs that the account experienced were overcome by a rising market. This defense ignores the fact that once the customer was invested, the costs of any further trading must be covered by returns in excess of the returns that would have been earned on the securities held prior to the trading. This is

usually financially impossible, especially during a market correction. The "control" defense also ignores the fact that the traditional criteria for determining control in churning cases focuses on who controlled the *trading costs*, not necessarily the trading itself.<sup>45</sup>

In almost all securities cases, the broker controlled the trading costs incurred by the customer. Although the customer typically testifies that they initiated none of the trading suggestions in their account, such an analysis is not outcome determinative since it is at the discretion of the brokerage firm as to the costs and commissions related to the trades.<sup>46</sup>

The excessiveness of trading in an account is assessed by reviewing the volume of trading using "turnover ratios" and the costliness of the trading using "cost-equity ratios."

Turnover ratios have been used in securities fraud cases for almost fifty years.<sup>47</sup> The simplest turnover ratio divides total purchases by the average equity balance or by the average value of the securities in the account, then annualizes the turnover ratio by dividing it by the number of years covered in the analysis.

Turnover ratios have traditionally been evaluated using the so-called "2-4-6 test," which holds that as the turnover ratio observed in the account increases from 2 to 6, the inference of churning grows from an indication to a presumption. There is no scientific basis for this rule.

Cost-to-equity ratios are a superior method (as compared to simple turnover ratios) of an indicator of churning because they directly measure the costliness of the trading.<sup>48</sup> Properly interpreted, they provide sound guidance as to whether the trading could reasonably have been expected to benefit the customer. Cost ratios measure the fraction of an investment consumed by trading costs. Annualized cost ratios yield the portfolio securities' breakeven rate of return; the account will show a profit if, and only if, the securities' gross returns exceed the cost ratio.

For the purpose of calculating the cost-equity ratio, the only relevant commission is the cost to the customer. There is ample authority for use of cost-equity ratios (as opposed to simple turnover rates).<sup>49</sup>

## Unsuitable Use of Margin

Margin cases come in two varieties. The most common is the unsuitable recommendation of a margin account, and the second is the “unauthorized liquidation” case.

Generally speaking, the typical issue in margin cases is that the broker did not explain to the customer (or simply that the customer did not understand) that the portfolio of stocks put up as collateral could be liquidated to meet margin calls.<sup>50</sup> Even if the margin agreement was signed by the customer, he may have had no understanding of what the “small print” implied.

The typical customer margin complaint in the context of liquidation cases include: allegations that the firm liquidated the account without giving the customer prior notice; the firm sent margin call with deadline for deposit of funds, but liquidated prior to deadline; and the firm liquidated the account after the deadline but did not allow the customer to participate in choosing which securities to liquidate.<sup>51</sup>

A claim of unsuitability often exists in margin cases if a broker recommends trades that create a margin deficiency. Certainly if a broker recommended a margin trade which the broker reasonably knew could create a margin call situation, and also knew the customer did not have sufficient assets to satisfy the margin call or did not understand the margin rules, a suitability claim could be made.

## The Growing Concerns Regarding Variable Annuity Sales

Annuities are insurance contracts in which the earnings are tax-deferred. Variable annuities are essentially a collection of mutual funds in a tax-sheltered wrapper. While the term “guaranteed” is closely associated with the sale of variable annuities, they are much more complex and have disadvantages that are typically not mentioned by the seller. The higher fees of most annuities can often cancel out their tax advantages. Most annuities lock in investors for years and saddle heirs with higher taxes, unlike mutual funds or most other investments.

As variable annuities and mutual funds relate to tax considerations,

compared with mutual funds (held outside of a variable annuity), the possibility of an investment loss endows the holder of the mutual fund with a real tax option to harvest those losses. The strategic investor can then re-establish a similar position at a lower tax basis and deduct any current losses against comparable gains. This creates a tax refund, which supplements the return from the mutual fund. This type of strategy cannot be easily employed within a variable annuity. Despite the favorable ordinary income treatment on losses sustained in a mutual fund, which can be netted against ordinary gains, lapsing or selling the variable annuity will induce severe surrender charges that would make such a decision financially impossible.

Variable annuity sales implicate a number of NASD rules and interpretive guidelines.<sup>52</sup> These rules contemplate a supervisory process in which a designated supervisor reviews and approves the opening of an account and a variable annuity transaction pursuant to standards established by member firms, taking into account the information collected about the customer.

NASD rules require that in recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of facts, if any, disclosed by the customer regarding his or her other securities holdings and financial situation and needs. In most cases, not only is the recommendation of a variable annuity unsuitable, but the recommendation of overly aggressive subaccounts is typically an aggravating factor.

In the context of variable annuities, sellers of variable annuities must make reasonable efforts to obtain information concerning the customer’s financial and tax status, financial objectives, and any other relevant information.<sup>53</sup>

In all fairness, there are some investors who might benefit from an annuity. Variable annuities may be a suitable investment if an investor meets the following criteria: the investor has maximized all other tax-advantaged retirement plans such as

401(k)s and IRAs and the investor’s tax bracket is at least 28%, otherwise tax-benefits will not outweigh the extra fees that variable annuities impose. High-income investors benefit because there are no maximum investment limits, as with IRAs and 401(k)s.

Who fits this profile? One may speculate that no investor would fit this profile.

Most variable annuity complaints address the sale of variable annuities as the funding vehicle for an IRA account. In this instance, the sales practice issues pertain to whether sales of variable annuities as funding vehicles for an IRA are suitable, given that the tax deferral of an IRA makes unnecessary the tax deferral aspect of the underlying variable annuity investment. Both the SEC and the NASD have issued guidance on qualified sales.<sup>54</sup>

From a tax perspective, the recommendation to purchase variable annuities often makes an investor’s tax situation worse.

In 1997 Congress cut the tax rate on long-term capital gains to 20%. Income produced from variable annuities is taxed at the annuitant’s top tax bracket (usually 31% or higher in the case of most investors). Tax considerations must be addressed in a suitability determination. Put simply, there is rarely a logical way that the seller of an annuity can justify transforming capital gains and losses into ordinary income tax rates. The widening gulf between the regular tax rates that ultimately apply to annuity earnings and the 20% rate from profits from straight mutual funds means that it takes longer for the benefits of tax deferral inside the annuity to overcome the loss of capital gains treatment.

The recent attention that has been paid to variable annuities is not just a product of regulators and the plaintiffs’ securities bar. The financial news media recognizes the same concerns. Not only are the general articles about variable annuities unflattering, they are universally condemning.<sup>55</sup>

## Variable Annuity Switching

Another corresponding topic concerning variable annuities is “switching” or “flipping” variable annuity contracts. The IRS allows an annuitant to exchange their existing annuity for

a new annuity without paying tax on the income and investment gains earned on the original contract.<sup>56</sup>

Switching has become a common complaint because variable annuities impose a variety of fees upon the initial investment, such as the following:

- **Surrender charges:** amount the customer owes if they withdraw from the annuity before a specified period
- **Mortality/expense risk charges:** amount the insurance company charges for the insurance risk it takes under the contract
- **Administrative fees:** amount charged for recordkeeping and other associated administrative expenses
- **Underlying fund expenses:** charges to customers relating to the investment options of the annuity
- **Other special charges:** expenses related to death benefits or guaranteed minimum income benefits

There is no question that the IRS allows customers the ability to exchange an annuity that a customer already owns for a new annuity without paying tax on the income and the investment gains earned on the original contract.<sup>57</sup> However, this is not an invitation for an investment professional to recommend the annuity switch without a suitable basis for the recommendation, as set forth below.

NASD has issued guidance on variable annuity switching.<sup>58</sup> Certainly it is the opinion of the insurance industry that there are several instances where switching an annuity to a new contract may make sense.

Many sellers base the sale of a variable annuity on the premise of a “bonus credit”; this practice is nothing short of unscrupulous. Bonus credits (1% in this instance) come at a cost, usually in the form of higher surrender charges, longer surrender periods, and increased mortality and expense fees. The customer will eventually pay more in the way of penalties and fees than they will have received as a credit. As outlined in the NASD *Investor Alert*, there are a litany of reasons why exchanging an annuity is

not a good decision.<sup>59</sup>

As a regulatory matter, the investment professional recommending the exchange of the annuity must advise the customer about the pros and cons of the exchange. Secondly, the broker is permitted to recommend such an exchange to the customer only if it is in their best interest and only after evaluating the customer’s personal and financial needs, tolerance for risk, and the financial ability to pay for the proposed contract.

### Financial Suicide Cases

Over the last several years, securities attorneys have brought—with a fair degree of success—customer claims against brokers on the grounds that the broker had an obligation to prevent them from engaging in risky trades and trading strategies, even when the broker did not recommend the strategy in question or control the customer’s account.<sup>60</sup> Most claims are derived from the broker’s duty of fair dealing and the broker’s duty to “know his customer.”

NASD rules require that a registered representative, when recommending investments, determine that such investments are suitable for the customer. The National Adjudicatory Council has confirmed this in *District Business Conduct Committee No. 7 v. Vaughan*.<sup>61</sup> Here, the NAC stated:

A broker must make a customer-specific determination of suitability, and he or she must recommend only those securities that fit the customer’s financial profile and investment objective. ...The broker must make recommendations based on the information he or she has about the customer, rather than on speculation.

Further, the NAC noted that even a purported sophisticated investor, who enjoys and encourages trading in speculative securities, is entitled to the protections of NASD Conduct Rule 2310. The NAC stated that a customer’s prior transactions are not relevant in a suitability determination, and a history of risky trading does not mitigate a broker’s conduct.<sup>62</sup>

The NASD has reached the same conclusion. In the case of *In re Robert J. Kernweis*,<sup>63</sup> NASD fined and censured

a registered representative for promoting a dangerous and risky trading strategy by a retiree with limited assets.

In sum, a brokerage firm cannot escape liability in this instance by claiming that “we only sold him the bullets.”<sup>64</sup>

### The Propriety of Fee-Based Accounts

A new development in this area of law deals with the propriety of fee-based accounts (or “wrap fee” accounts). These “managed” portfolios leveled fees of 1% to 2.5% of the total assets under management for each investor. Oftentimes, these fees are unconscionable and unjustifiable.<sup>65</sup>

For a brokerage firm, the strategic advantages of fee-based accounts are immediately apparent, such as annuitizing commission income and realizing substantial savings through reductions in retail brokerage personnel. Firms often suggest to their customers that for a low annual fee they can obtain the services of a professional, pooled-investment manager (to do what the customer expected the broker to do) for no greater expense than normal transaction costs. The more the customer commits to the program, the lower the annual fee percentage.

The intended consequences of fee-based accounts are (1) the annuitization of commission income regardless of market conditions and account activity; (2) the selling of unnecessary services to customers; (3) the separation of brokers from investment recommendations, eliminating some types of potential commission-driven liability; (4) the binding of the customer to the brokerage firm, making transfer of accounts difficult; and (5) the promotion of an erroneous perception that wrap-fees eliminate conflicts of interest.

If the wrap-fee includes asset-management, a broker no longer has to actively manage his accounts to generate commission income. By parking a customer’s investments in any number of fee-based managed accounts or pooled funds, the broker will free him- or herself to focus on marketing activities, financed by annual fee income for the life of the customer.

Brokerage firm publications and promotional materials represent that

wrap-fees eliminate conflicts of interest, ostensibly because they substitute fees for commissions (as if churning were the only concern!). Despite these lofty claims, fee-based accounts are replete with undisclosed conflicts of interest that can support claims of material misrepresentation.

From a practical standpoint, do customers really need active portfolio management as well as the annual-fee percentage? The answer is more than likely, no.

For example, why would a retiree's IRA account need to be actively managed? As illustrated in the damage analysis below, these customers would have been much better off being invested in bonds and mutual funds, where the transaction costs would have been minimal. If respondents had placed these IRAs in A share mutual funds, all the customers would have realized substantial breakpoints and qualified for very low management fees.<sup>66</sup> Instead, they chose the most expensive investment route for them.

Low-fee accounts will always grow faster than fee-based accounts and without the additional hurdle of the fee; the non-fee account can accomplish its objectives far less aggressively.

In short, fees mandate higher-risk investments. The customer in this case sees 10% projections and is not sophisticated enough to perceive when 10% really means 12.5% or higher.

Wrap-fees and managed accounts typically facilitate a broker's promotional and marketing activities, something that most brokers engaged in traditional account management activities have little time to do, *i.e.* a broker can churn only a few accounts at a time, but asset-fees can be applied across the board to all customer accounts. Churning is a tactical violation against the individual customer; wrap-fee accounts are structural changes focusing on maximizing revenues from the broker's book while facilitating the marketing capability of the broker.

Wrap-fees should mandate regular supervisory reviews to protect the client against excessive costs on low or moderate turnover accounts. There should be an analysis annually to compare fees with commissions. Most bro-

kerage firms fail to fully disclose costs and to supervise the recommendation of fee-based accounts.

## Conclusion

In conclusion, representing investors in securities fraud actions requires an attorney to be well-versed not only in securities laws and the securities arbitration process, but also competent in the financial markets and the multitude of investments available to customers.

In an area of the law that is relatively new and constantly developing, counsel should consider Kansas rights of recovery to the maximum extent possible. While many commentators speculate that the market decline that decimated so many retirees' portfolios in 2000-2002 is over, it is this author's opinion that while the dust has settled for the time being, this area of law will continue to develop and grow as more and more retirees leave the workforce and enter retirement. ♦

## Endnotes

<sup>1</sup> See *Shearson/American Express v. McMahon*, 482 U.S. 220 (1987).

<sup>2</sup> See NASD Notice to Members 99-90 ("NASD Discovery Guide").

<sup>3</sup> K.S.A. 17-1252 *et seq.* (2003 Supp.).

<sup>4</sup> See 1911 Kan. Sess. Laws 133.

<sup>5</sup> See 69A AM. JUR. 2D *Securities Regulation* §1 (1993).

<sup>6</sup> *Id.*

<sup>7</sup> See K.S.A. 17-1268 (2003 Supp.).

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> The statutory measure of recovery can be measured as follows:

Recovery = (consideration paid + 15% interest from the date of purchase + costs + attorneys' fees) – (any income received from the securities).

<sup>11</sup> The original text of the Uniform Securities Act (1957) defined damages. It provided that: "damages are the amount that would be recoverable upon tender less the value of the security when the buyer disposed of it and interest at 6% per year from the date of disposition." See also Official Comment to § 410(a): Measure of Damages, 7b Uniform Laws Annot. 644 (Master Ed. 1985); 1 Blue Sky L. Rep. (CCH) ¶5550.

<sup>12</sup> *Supra* note 7.

<sup>13</sup> *Id.*

<sup>14</sup> Fed. Sec. L. Rep. ¶ 96,016 (1977).

<sup>15</sup> 17 C.F.R. § 240.10b-5.

<sup>16</sup> See note 13, *supra*, at \*5 ("[T]he application of such profits as an offset against losses realized in separate, unrelated transac-

tions would be an unwarranted windfall to the wrongdoers.")

<sup>17</sup> It should be noted that in *Clinton Oil* all purchases and sales were in the same stock and netting was denied as improper. In virtually all cases that this author has been involved in where damage amounts are disputed, the respondents will almost always argue netting on different, suitable securities. It is contrary to the law and should not be permitted.

<sup>18</sup> *Kane v. Shearson Lehman Hutton, Inc.*, 916 F.2d 643 (11th Cir. 1990) (interpreting Florida's blue sky counterpart of the Kansas Securities Act); *In Re McDowell*, 87 E.R. 554, 560 (S.D. Ill. 1988) (investor who engaged in several separate purchases of unregistered securities sold in violation of Wisconsin's securities statutes had the option of electing to rescind only the unprofitable ones); *Piantes v. Hayden-Stone, Inc.*, 30 Utah 2d 110, 111, 514 P.2d 529, 530 (1973) (under Utah law, netting not required; statute permits rescission of any purchase that the purchaser chooses to make); *Treider v. Doherty & Co.*, 86 N.M. 735, 737, 527 P.2d 498, 501 (N.M. Ct. App. 1974) (under New Mexico law, securities plaintiff is entitled to void any sale violating securities statute regardless of profit made on other sales); *Crater v. International Resources, Inc.*, 92 Ohio App. 3d 18, 25, 633 N.E.2d 1212, 1216 (1993) (applying Ohio securities statute); *Dixon v. Oppenheimer & Co., Inc.*, 739 F.2d 165 (4th Cir. 1984) (under Virginia law, the buyer of securities may recover damages for any sale of securities regardless of whether the buyer happened to profit from other sales.)

<sup>19</sup> *Kane v. Shearson Lehman Hutton, Inc.*, 916 F.2d 643 (11th Cir. 1990).

<sup>20</sup> 916 F.2d at 646.

<sup>21</sup> *Id.*

<sup>22</sup> 906 F.2d 1206, 1218 (8th Cir. 1990) ("If we were to adopt Merrill Lynch's view, securities brokers would be free to churn their customers' accounts with impunity so long as the net value of the account did not fall below the amount originally invested.")

<sup>23</sup> The courts' overwhelming rejection of netting is rooted in the U.S. Supreme Court's decision in *Randall v. Loftsgaarden*, 478 U.S. 647 (1986). In *Randall*, the Supreme Court, interpreting the rescissionary damages remedy under §12(2) of the Securities Act of 1933, upheld a defrauded investor's right to a full recovery with no offset for tax benefits the investor received while owning the security. The Supreme Court reasoned that, because the federal securities laws serve the dual purpose of deterring fraud and compensating defrauded investors, an investor's recovery should not be

limited to mere net economic loss.

The Court stated, “rescission... adds an additional measure of deterrence as compared to a purely compensatory measure of damages.” The Court acknowledged that the rule against netting potentially puts the purchaser in a better position than he would have been absent the fraud, but said, “[it] is more appropriate to give the defrauded party the benefit of any windfall.

*Randall* is clearly on point, because of the similar language under Kansas law and §12(a)(2) under which an investor is entitled to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security. . . . 15 U.S.C. §771(2).

<sup>24</sup> The basic premise of suitability is rooted in NASD Rule 2310 and NYSE Rule 405. Rule 2310 (Recommendations to Customers) requires that a member have “reasonable grounds for believing that the recommendation is suitable for each customer upon the basis of facts, if any disclosed by such customer as to his other security holdings and as to his financial situation and needs.” Furthermore, the Rule requires that a broker is duty-bound to obtain information concerning the customer’s financial status, tax status, investment objectives, and other information used or considered to be reasonable by the broker in making the recommendation to the customer.

<sup>25</sup> *Zaretsky v. E.F. Hutton*, 509 F. Supp. 68, 75-76 (S.D.N.Y. 1981).

<sup>26</sup> The concept of diversifying is so basic that it simply goes without saying. Morgan Stanley’s May 2002 *Perspectives* publication states: “When something stands the test of time, proving its worth again and again, we call it a classic. In the investment world there’s a classic piece of advice: Diversify.”

<sup>27</sup> Generally speaking, the primary market sectors are financial services, real estate, technology, consumer goods, healthcare, and technology, among others.

<sup>28</sup> Support for concentration as a negligent act can be found in NASD Rule 2310(a) which requires that a member “have reasonable grounds for believing that the recommendation is suitable for each customer...” and in NASD IM-2310-2(a)(1) which imposes on stockbrokers “the fundamental responsibility for fair dealing.”

<sup>29</sup> *In re Jeffrey L. Salzwedel*; [NASD October 1998] (censured, fined \$107,000 and suspended from association with any NASD member in any capacity for 30 days for the concentration of securities held in the accounts); *In re Daniel Richard Howard* [NASD February 1999] (broker did not have reasonable grounds for believing that the recommendations and resulting

transactions were suitable for the customer in view of the size, frequency, and concentration of speculative securities); *In re John Robert Van and Michael Edward Murphy* [NASD October 2000] (fined \$10,000 and suspended from association with any NASD member for 15 business days for acting in disregard of their customers’ interests when they disregarded the impact of use of margin and the concentration levels of certain securities; *William Joseph Shaughnessy* [NASD April 2001] (censured and fined \$10,000 for making unsuitable recommendations for the joint securities account of public customers that resulted in an over-concentration of precious metals-related investments in the account); *In re John Richard Coleman* [NASD February 2002] (fined \$7,500 and suspended from association with any NASD member in any capacity for 10 business days for writing options against highly volatile and speculative stocks for the trust account of a public customer in light of the size and nature of the transactions and the concentration of speculative securities; *In re Fulton Gregory Cook*, NYSE 99-170 (1999) (“Cook over-concentrated the account in XYZ and UVW, which constituted approximately 78% and approximately 16.8%, respectively, of the market value of the account portfolio... the highly margined over-concentration in two speculative securities was unsuitable, in light of the investment objectives, financial resources and investment experience of AC and his wife.”); *In the Matter of Henry James Faragalli*, NYSE Hearing Panel Decision, 94-61, p. 25 (1995) (broker suspended for nine years for failing to advise customer of the risk of concentration).

<sup>30</sup> *Securities America, Inc.* [NASD January 1999] (firm was censured and fined \$10,000 for the firm’s deficient supervisory procedures concerning the methodology for supervision of account activity, concentration, and use of margin in connection with accounts located in single person Offices of Supervisory Jurisdiction and branch offices; *In the Matter of PaineWebber*, SEC Administrative Proceeding File No. 3-8928 (1996) (“The Branch Office Manager failed reasonably to supervise the RR’s activities by failing to take reasonable measures to investigate clear signs of over-concentration in accounts of the RR’s customers.”)

<sup>31</sup> See David L. Scott, *Wall Street Words*, 1998 (“For example, an investor would not want to combine large investment positions in airlines, trucking, and automobile manufacturing because each industry is significantly affected by oil prices and interest rates.”); see also *Barron’s Dictionary of Finance and Investment Terms* (1985) (defining “diversifica-

tion” as the “spreading of risk by putting assets in several categories of investments — stocks, bonds, money market instruments, and precious metals, for instance, or several industries, or a mutual fund, with its broad range of stocks in one portfolio.”)

<sup>32</sup> It is often relevant to utilize guidelines that are attributable to certain firms. In the prospectus for the *Equity Investor Fund-Broadband Portfolio 2000* (sponsored by Merrill Lynch, PaineWebber, and Morgan Stanley) in the section entitled “The Risks You Take” it states: “When stocks in a particular industry or country make up 25% or more of the Portfolio, it is said to be ‘concentrated’ in that industry, which makes the Portfolio less diversified.”

<sup>33</sup> See *John M. Reynolds*, 50 S.E.C. 805, 809 (1992) (regardless of whether customer wanted to engage in aggressive and speculative trading, the broker was obligated to abstain from making recommendations that were inconsistent with the customer’s financial situation); see also *In re Venters*, 51 S.E.C. at 294-95 (notwithstanding client’s interest in investing in speculative securities, broker had duty to refrain from recommending such investments when he learned about his customer’s age and financial situation).

<sup>34</sup> See *in re Belden*, Rel. No. 34-47859 (May 14, 2003) (“The test for whether Belden’s recommended investments were suitable is not whether Book acquiesced in them, but whether Belden’s recommendations to him were consistent with Book’s financial situation and needs.”); see also *in re Piontek*, Rel. No. 33-8344 (Dec. 11, 2003) (“The test for whether Piontek’s recommendations were suitable is not whether Dean or Hamby acquiesced in them, but whether his recommendations were consistent with their respective financial situations and needs.”); see also *NASD Regulation Inc., Office of Hearing Officers Dep’t of Enforcement v. Stein*, Disciplinary Proceeding No. C07000003 (March 6, 2001) (“For purposes of this decision, the Panel assumes that EA was not naive and that she knowingly authorized or acquiesced in all of the transactions, knowing the risks involved. Stein’s reliance on such facts nevertheless does not constitute a defense to a charge of making unsuitable recommendations.”); see also *NASD Regulation Inc., Office of Hearing Officers Dep’t of Enforcement v. Mazzei*, et. al., Disciplinary Proceeding No. C10970120 (June 24, 1998) (“But even if RB did change his investment goals from growth and income to ‘aggressive growth’ that circumstance, standing alone, would not constitute a defense. Respondent’s responsibility goes beyond mechanical obedience to all customer demands.”)

<sup>35</sup> See NASD Conduct Rule 2310.

<sup>36</sup> The customer can often combat the ratification defense by way of testimony that reflects that the customer consented to the broker's actions based on the fact that he did not have full knowledge of all material facts, including the risks of the recommended investment. See *In re Rangen*, 52 S.E.C. 1304 (1997).

<sup>37</sup> *Rowe v. Morgan Stanley Dean Witter*, 191 F.R.D. 398 (D.C.N.J. 1999); *Arioli v. Prudential-Bache Sec., Inc.*, 792 F. Supp. 1050, at 1062 (E.D. Mi. 1992), *Pross v. Baird, Patrick & Co., Inc.*, 585 F. Supp. 1456 (S.D.N.Y. 1984); *Bischoff v. G.K. Scott & Co., Inc.*, 687 F. Supp. 746 (E.D.N.Y. 1986).

<sup>38</sup> 59 F. Supp. 2d 280 (D. Puerto Rico 1999).

<sup>39</sup> 59 F. Supp. 2d at 292 (citing *Village of Arlington Heights v. Poder*, 712 F. Supp. 680, 683 (N.D. Ill. 1989)).

<sup>40</sup> 901 F.2d 1124 (D.C. Cir. 1990).

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> "A primary test for excessive trading is the relationship between the net amount of money invested and the transaction costs that are incurred." See *In re Sweeney*, SEC Release No. 34-29884 (October 30, 1991); see also *In re Shearson Lehman Hutton*, SEC Release No. 34-26766 (April 29, 1989).

<sup>44</sup> See Louis Loss and Joel Seligman, *Securities Regulation* 3875 (3d ed. 1991) ("Churning, in essence, involves a conflict of interest in which a broker seeks to maximize his or her remuneration in disregard of the interests of the customer.")

<sup>45</sup> Traditional analysis of control focuses on whether the broker or the customer selected the securities to buy and sell and which to hold.

<sup>46</sup> See, e.g. R. Ibbotson and P. Kaplan, *Financial Analysts Journal*, Vol. 56, pp. 26-33 (Jan-Feb. 2000); G. Brinson, R. Hood, and G. Beebower, *Financial Analysts Journal*, Vol. 42, pp. 39-38 (July-Aug. 1986).

<sup>47</sup> See *R.H. Johnson Co. v. S.E.C.*, 231 F.2d 528 (1956); see also *In re Looper & Co.*, 38 S.E.C. 294 (1958).

<sup>48</sup> To arrive at the cost-equity ratio, calculate the annualized expenses (i.e., what the expenses would have been if stated as an annual number instead of a total number for all the months). To do this, take the total commissions, divide by the number of months in which there was activity and then multiply by 12. The resulting number is the annualized expenses.

Second, look at the average monthly balance then divide the average monthly balance by the annualized expenses to arrive at the cost-equity ratio. For example, if the cost-equity ratio was 15%, this means that the account needed to make 15% per year on the average monthly balance each year just to break even.

<sup>49</sup> See Howard Berg and J. Julie Jason, *Does the Literature of Churning Reflect the Current State of the Brokerage Industry?*, Securities Arbitration 1996, Vol. 2., Practising Law Institute ("In view of expected performance over time—commissions of about 5% to 6% annually in a brokerage account with a growth and income investment objective over which a broker exercises control is probably about the limit the account can bear.").

<sup>50</sup> Under margin rules, a customer must, within a short period after the purchase of a stock, either pay for that security or put up adequate collateral in a margin account to secure a loan from the brokerage firm for that purchase. Should the customer fail to put up sufficient capital or fail to provide additional capital when necessary, the brokerage firm has the right to sell as much of the customer's securities that will bring the account in to conformity with the margin requirements.

<sup>51</sup> See T. Krebsbach & J. Friedman, *Securities Arbitration: Defending a Brokerage Firm*, SECURITIES ARBITRATION 1989 (PLI).

<sup>52</sup> Although not an exhaustive list, NASD Conduct Rules 3010 (Supervision), 2310 (Suitability), and 3110 (Customer Account Rule) shape the process that brokerage firms must follow in supervising sales practices and determining suitability compliance.

<sup>53</sup> Relevant information includes: current insurance coverage, customer's express preference for investments other than insurance products, customer's ability to understand the complexity of variable annuities, willingness to invest a set amount on a yearly basis, need for liquidity and short term investment, immediate need for retirement income, and investment sophistication.

<sup>54</sup> See NASD *Notice to Members* 00-44, 99-86, 99-35, 97-27; NASD *Investor Alert* (May 27, 2003); see also Joint SEC/NASD Staff Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products (June 9, 2004). The 2003 NASD *Investor Alert* includes a discussion warning investors that a variable annuity offers no additional tax advantage for an IRA investment, and that an investor should only consider buying a variable annuity in that circumstance only if the annuity's other features, such as death benefit protection, make sense to the investor.

NASD views and guidance appear primarily in the Notices to Members. Inferences can also be drawn from the recent complaints filed against member firms. The NASD notice highlights the following recommended practices to firms:

- When a registered representative recommends the purchase of a variable annuity for an IRA, the representative

should disclose to the customer that the tax deferral feature is provided by the tax-qualified retirement plan and that the tax deferral accrual feature of the variable annuity is unnecessary

- The registered representative should recommend a variable annuity only when its other benefits, such as lifetime income payments, family protection through the death benefit, and guaranteed fees, support the recommendation

- A member should conduct an "especially comprehensive suitability analysis" prior to approving the sale of a variable annuity with surrender charges to a customer in a tax-qualified account.

<sup>55</sup> "The Fifth Best Option" *Business Week*, May 8, 2000 ("Steep fees, limited flexibility and taxation as ordinary income, not capital gains."); "The Great Annuity Rip-Off" *Forbes*, February 9, 1998 ("...because they're stupid investments for nine and a half people out of ten. The only people who benefit from these things are the people who sell them."); "Why Variable Annuities Are Just For a Few" *Kiplinger's*, March 30, 2003 ("More smoke and mirrors can't disguise the simple truth about variable annuities: most investors can do better elsewhere."); "One (small) Cheer for Variable Annuities" *Money*, January 2000 ("If you insist on buying, hold off until you're close to or even in retirement so you can cut back on the length of time your money is being hit up by those insurance charges."); "One Faulty Investment" *Newsweek*, August 30, 2004 ("I cannot imagine a personal financial situation where I'd recommend a [variable annuity] as a good idea." (Quote from John Biggs, former chair of TIAA-CREF)).

<sup>56</sup> See IRC § 1035. It is important to note that the insurance industry uses the term "replacement" for a transaction in which a new annuity contract is to be purchased from the proceeds of an existing annuity. Although the term "1035 exchange" is often used to describe any form of replacement activity, especially regarding variable annuity replacement activity, technically not all replacements are Section 1035 exchanges and as a consequence are not tax-free.

<sup>57</sup> IRC § 1035.

<sup>58</sup> NASD *Investor Alert* (February 15, 2001).

<sup>59</sup> Bonus payments are offset by the new charges assessed by the new annuity; new surrender charge periods are imposed with the new annuity; higher fees for the new contract may be imposed; large commission for the broker recommending the switch.

<sup>60</sup> See L. Lowenfels & A. Bromberg, *Beyond Precedent: Arbitral Extensions of Securities Law*, 57 BUS. LAW. 999, 1011-13 (2002).

<sup>61</sup> NAC Docket C07960105 (1998).

<sup>62</sup> *Id.* at \*7 ("Even if a respondent had ex-

plained the risks to a customer, the securities he recommended for her accounts would still have been unsuitable. The SEC has made it clear that even in those situations where a customer seeks to engage in highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile.")

<sup>63</sup> NASD Docket C02980024 (2000) ("Even if FPG appreciated at least some of the risks of the trading strategy recommended by Kernweis, the Panel finds that he financially was unable to bear the risks associated with frequent purchases and sales of large amounts of speculative stocks on margin at the extraordinary high trading costs attendant to the recommended trading strategy. The Panel finds that regardless of FPG's apparent endorsement of, and enthusiasm for, the recommended speculative investment strategy, Kernweis had a duty to recommend investments that did not risk FPG's entire net worth.")

<sup>64</sup> A broker's responsibility goes beyond mechanical obedience to all customer demands. *Clyde J. Bruff*, 50 S.E.C. 1266, 1269 (1992) ("Having undertaken to act as an investment counselor for the Patterson's, Bruff was required to make only such recommendations as were in

their best interests. Thus even if the Patterson's wished to engage in aggressive and speculative options trading, Bruff was obliged to counsel them in a manner consistent with their financial situation."); see also *Charles W. Eye*, 50 S.E.C. 655, 658 (1991) ("Her request for a plan to increase her income was not a warrant to escalate risks unduly. If the only approach capable of producing the desired income involved significant dangers, Eye should have advised against it."); *Eugene J. Erdos*, 47 S.E.C. 985, 988 (1983), aff'd 742 F.2d 507 (9th Cir. 1984) ("Even though Mrs. C. may have desired 'quick profits,' that did not entitle Erdos to ignore here individual situation and place her limited assets in risky investments."); *District Business Conduct Committee v. Michael R. Euripides*, C9B950014, 1997 NASD LEXIS 45 (1997) (representative has consultative duty when customers wish to engage in trading that is inconsistent with their financial situation.).

<sup>65</sup> For example, a \$200,000 portfolio with a 2% wrap-fee generates an annual fee that is identical to 1% commissions with annual turnover of 100% buys and 100% sells. A conservative portfolio, with turnover of 30% buys and 30% sells, would produce commissions of \$18,562 at 1.25% over 10 years in contrast to \$46,446 in

wrap-fees (250% of commissions) over the same period, an excess of \$27,885 (\$2,788/year) in costs.

The conclusions are evident, for conservative accounts with less than 100% turnover/year an investor is likely to be far better off paying the commissions. This type of analysis will persuade an arbitration panel that for many conservative and senior citizen investors, wrap-fees equate to a structural commission driven abuse that heavily rewards the broker and offers only illusory benefits to the customer.

<sup>66</sup> Class A shares typically have a sales charge that is paid when you invest in the shares. This is called a "front load" because the commission is paid upfront. Front loads vary by fund but usually range from 3 percent to 5.75 percent. Class B shares typically have deferred sales charges. Investors pay the sales charge when the fund is sold, and the amount of the sales charge declines each year. Often with Class B shares there is no deferred sales charge if you sell the fund after owning it for five to seven years. However, Class B shares have higher annual expense ratios than Class A shares, so the broker can be compensated from these annual fees. With the Class A shares the broker is paid upfront, and you pay lower annual expenses.

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